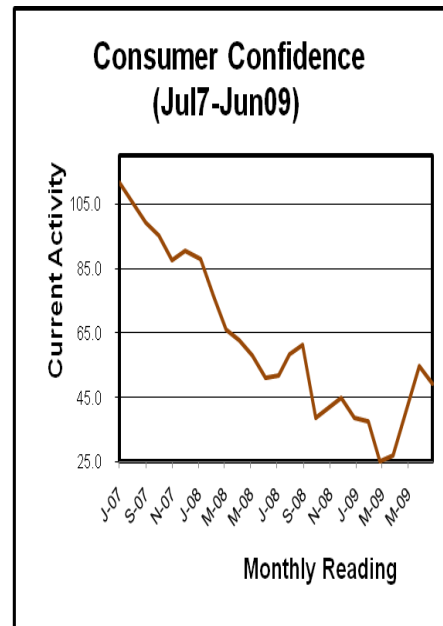


# YSWM, LLC

## Client Letter



Situation Analysis

Financial Market Review

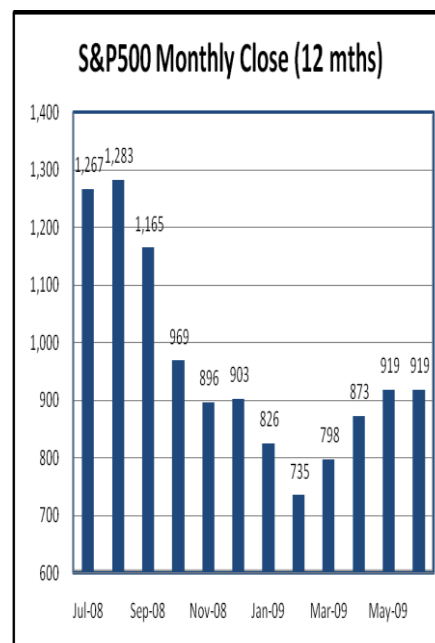
Economic Review

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Written By:

Robert Samrah, CFA

July 14, 2009



# YOLLES-SAMRAH WEALTH MANAGEMENT, LLC

## SITUATION ANALYSIS

### **Conclusion 1 – Financial conditions remain soft but are much improved from last fall and late winter.**

Let's begin by stating that from both a market and economic perspective 2Q09 was clearly better than 1Q09 which was slightly better than 4Q08. Financial conditions remain fragile and economic growth negative but with each passing day it appears that stocks and corporate bonds have bottomed and the rate of economic decline is slowing at an increasing rate. To help illustrate the recent improvement and provide historical context, we examined the S&P500 performance using daily, quarterly and rolling 12 month statistics.

Listed in **Table 1** is select data for inflection months compared to Jun09, the close of the second quarter. The table includes the S&P500's closing price, trailing three-month price change (G3), trailing twelve-month price change (G12), and the standard deviation of the trailing twelve-month price change (SD12).

Reading from bottom to top, the market peaked in Oct07, up 6.5% during the preceding three-months and 12.4% for the last twelve-months with a monthly standard deviation of return of 2.3%. After the severity of the financial crisis became clear in mid-Sep09 and numerous large institutions were saved from bankruptcy by government funding, the S&P500 tumbled to 969 with trailing stats of -23.6% and -37.5% and 5.8% standard deviation. From Oct08 to Feb09 the economy grinds to a halt and reaches its lowest monthly closes since 1997 at 735 with trailing stats of -18%, -44.8% and 6.5% standard

deviation, one stat better and two stats worse.

Finally in March after six months of massive inventory liquidation and numerous waves of production cuts, the world begins to thaw as businesses start to reorder inventory and consumers cautiously shop for bargains. The S&P500 closes the quarter up 15.2% and the rolling-twelve month return improves to -28.2% with an almost unprecedented 8.2% standard deviation, two stats better and one worse.

<b>Table 1 - S&amp;P500 Monthly Stats</b>				
<b>Month</b>	<b>Price</b>	<b>G3</b>	<b>G12</b>	<b>SD12</b>
Jun09	919	15.2%	-28.2%	8.2%
<b>Bottoming process begins ... inventory rebuild in Q2 as leading indicators improve</b>				
Feb09	735	-18.0%	-44.8%	6.5%
<b>Economy grinds to halt with inventories slowly depleted</b>				
Oct08	969	-23.6%	-37.5%	5.8%
<b>Credit crisis peaks as numerous large banks are rescued by government loans</b>				
Oct07	1,549	6.5%	12.4%	2.3%
<b>Stock market peak on high energy prices and global R/E boom</b>				

**Table 2** shows daily stats for the month of Oct07 then monthly Oct08 to Jun09 including the average monthly closing price (P), the daily standard deviation for each month (SD), the twelve month earnings forecast (e) and the implied price-earnings ratio (P/e) using the average price. The average price peaked in Oct07 at 1,540 with a daily standard deviation of 1.2%, forward twelve months earnings at \$100 and an implied P/e of 15.4. Post-crisis the average price

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tumbled nearly 40% in conjunction with collapsing earnings as the daily standard deviation exploded to 8.3%; that's daily. The average price continued to move lower before bottoming at 760 in Mar09 with daily volatility climbing back to 6.4% then falling to around 2% during Q2 which is still high but much closer to long term averages. The average price has slowly climbed higher from the March low; 760, 849, 905 and finally 929 in June with an intraday peak of 956 on 6/11/09. 12-month forward earnings forecasts were slow to decline immediately after the crisis hit which produced a "head-fake" rally from 752 on 11/20/08 to 913 on 12/16/08. Eventually earnings were lowered by almost 50% to \$52 before a recovery in May and June to around \$60.

<b>Table 2 - S&amp;P500 Daily Stats</b>				
Month	Average Price	SD Daily	F(e)	Implied P/e
2009-06	929	2.0%	60	15.5
2009-05	905	1.5%	58	15.6
2009-04	849	2.1%	54	15.7
2009-03	760	6.4%	52	14.6
2009-02	807	5.0%	52	15.5
2009-01	866	4.5%	55	15.7
2008-12	880	2.6%	56	15.7
2008-11	886	6.9%	58	15.3
2008-10	968	8.3%	60	16.1
2007-10	1,540	1.2%	100	15.4

If we use a long term average multiple of around 15 and a forward earnings target at \$60, S&P500 fair value is around 900. Best case scenarios might entail some multiple expansion and/or upward revisions to earnings perhaps pushing the S&P500 above 1,000 while worst

case scenarios might include multiple contraction (12x\$60) and/or overly optimistic assumptions used to support a \$60 estimate (15x\$52). Q2 earnings reports will be released in the coming weeks and should provide some help for Wall Street forecasters. The Public Private Investment Partnership (PPIP) continues to move forward with the U.S. Treasury selecting nine money managers and is expected to provide \$30b for funding the initial purchases of so-called bank "legacy assets". The expectation is that an auction process, albeit government controlled, will **provide some clarity on asset pricing** with private capital eventually owning the auctioned assets.

**Conclusion 2 – This is no ordinary bear market with only two other periods from 1950 to 2009 that exhibit similar market losses and price volatility.**

To better understand recent stock price volatility and how valuations will adjust moving forward, we examined historical monthly S&P500 data looking for other extreme periods. The below **Table 3** shows all quarters (rolling three months) from 1950 to Jun09 with an absolute price change greater than 25%.

<b>Table 3 - S&amp;P500 % Price Change &gt; abs(25%)</b>			
Month	G12	SD12	G3
May-09	-34.4%	8.4%	25.0%
Nov-08	-39.5%	6.0%	-30.1%
Nov-87	-7.6%	8.6%	-30.2%
Sep-74	-41.4%	4.6%	-26.1%

Note this only occurred during four periods; Sep74, Nov87, Nov08 and May09 which is less than one percent of the 715 observations with two

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occurrences (50%) in the last nine months. We also examined rolling twelve months periods, in the post 1950's era, with an average price decline of greater than -35% and found only one other period (Sep74) other than the seven month period from Oct08 to Apr09.

<b>Table 4 - Rolling 12-Month Standard Deviations &gt; 8%</b>			
<b>Month</b>	<b>G12</b>	<b>SD12</b>	<b>G3</b>
Jul-09	-29.1%	8.2%	3.0%
Jun-09	-28.2%	8.2%	15.2%
May-09	-34.4%	8.4%	25.0%
Apr-09	-37.0%	8.1%	5.7%
May-88	-9.6%	8.0%	-2.1%
Apr-88	-9.4%	8.0%	1.7%
Mar-88	-11.2%	8.0%	4.8%
Feb-88	-5.8%	8.0%	16.3%
Dec-87	2.0%	8.8%	-23.2%
Nov-87	-7.6%	8.6%	-30.2%
Oct-87	3.2%	8.2%	-21.0%
Jul-75	11.9%	8.5%	1.7%
Jun-75	10.7%	8.6%	14.2%
May-75	4.4%	8.6%	11.7%
Apr-75	-3.3%	8.6%	13.4%
Mar-75	-11.3%	8.5%	21.6%
Feb-75	-15.2%	8.5%	16.6%
Jan-75	-20.3%	8.2%	4.2%

The rolling 12 month standard deviation of monthly price change reached 8.4% in May09. This too is statistically very rare with only two other occurrences holding above 8% as shown in **Table 4**. Both periods lasted seven months; after the Oct87 stock market crash and from Jan75 to Jul75. This cycle has held 8% for only four months peaking at 8.4% in May09 as compared to 8.8% in Dec88 and 8.6% in Jun75. In all three occurrences the rolling 12-month price

change was improving as volatility peaked.

Obviously we are concerned about outcomes like the 70's where the S&P500 traded near 100 in the early 80's after reaching 107 in 1968, approximately a 14 year sideways period. The S&P500 closed June at 919, a price first reached in 1997, then retested in 2002 and again in 2008, that's over 12 years encompassing one mild recession and the current deep recession as compared to 14 years with two quite deep and long recessions in the 70's and early 80's. The 1987 crash didn't cause depressed valuations for a protracted period but did eventually contribute to the 90-91 recession.

**Conclusion 3 – Data doesn't support a depression and looks more like the 70's in terms of economic growth rates, stock market performance and the balance of power in Washington.**

Next we examined the current recessions relative to past recessions looking for similarities and patterns that might help us better understand where we are in the process and how long to recovery. Appendix A lists all quarters with negative real GDP since 1945 grouped into nine periods which are summarized in the below Table 5.

Excluding 2Q09 which is likely -2.5%, 40 other quarters were negative or approximately 16% of time during this 64 year period. The average decline was -2.9% with a 2.5% standard deviation. Nominal or current dollar GDP declined only 14 quarters or approximately 6% with 11 of the 14 periods occurring before 1960. The three post 1960 quarters, 1Q82 plus the last two quarters of the current recession, 4Q08 and 1Q09

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which declined at a seasonally adjusted current dollar rate of -5.8% and -3.1% and real dollar rate of -6.3% and -5.5%, respectively.

Sharp back-to-back quarterly declines occurred in two other periods, 4Q81 and 1Q82 and 4Q57 and 1Q58. Three straight quarterly declines occurred only once from 3Q74 to 1Q75 before the current recession which likely reached its third consecutive quarterly decline in 2Q09. The 2007-09 cumulative declines will unfortunately be larger than 1974-75 although we will not receive the final data for a few months. No other post WW2 recession has experienced a fourth straight down quarter.

The below **Table 5** includes the average growth rate, the standard deviation and the rolling 10-year average growth rate at the end of the recessionary period. The current recession (2007-09) period has experienced four down quarters which is about average (4.4q) but its decline was below average at 3.1% (fourth worst) with the second highest standard deviation and the worst trailing 10-year growth rate of only 2.0%. The 1980-82 recession data seems most similar relative to today.

<b>Table 5 - Recessionary Real\$ Stats</b>			
Period	Avg (g)	Std Dev (g)	10 Yr Avg
1947-49	-2.3%	2.5%	Ending
1953-54	-3.5%	2.3%	Quarter
1956-60	-3.2%	3.4%	3.0%
1969-70	-2.3%	1.8%	4.3%
1973-77	-2.6%	1.7%	3.2%
1980-82	-4.1%	2.8%	2.3%
1990-91	-2.5%	0.7%	2.9%
2000-01	-0.8%	0.5%	3.3%
2007-09	-3.1%	3.2%	2.0%
<b>Average</b>	<b>-2.9%</b>	<b>2.5%</b>	<b>3.3%</b>

Rank      Fourth      Second      Last

The below **Table 6** includes the number of negative quarters during the recessionary period, the current dollar growth rate and the implied inflation; i.e., the difference between the current dollar and real dollar growth. The 2007-09 recessions has two fewer down quarters than the 1973-77 and 1980-82 recessions, it's the first recession since the 50's to exhibit negative current dollar growth largely related to the deleveraging of both personal and corporate balance sheets. The 1956-60 data looks the most similar to 2007-09 and like Table 5 seems to suggest a few more negative quarters although not necessarily sequential. The obvious difference between the 70's and today is very low inflation at 2.3% as compared to very high inflation of 9.6 and 7.2% during the mid 70's and early 80's recessions, respectively.

<b>Table 6 - Recessionary Current\$ Stats</b>			
Period	# of Quarters	Current \$ Growth	Inflation Rate
1947-49	5	-0.8%	1.6%
1953-54	3	-2.3%	1.2%
1956-60	8	-0.7%	2.5%
1969-70	3	3.1%	5.3%
1973-77	6	7.0%	9.6%
1980-82	6	3.2%	7.2%
1990-91	2	1.3%	3.8%
2000-01	3	1.5%	2.3%
2007-09	4	-0.8%	2.3%
<b>Total/Avg.</b>	<b>40</b>	<b>1.4%</b>	<b>4.3%</b>

**Conclusion 4 – using history as a guide, we are getting closer to the end but expect another two or three negative GDP quarters with depressed asset valuations for perhaps another year or two.**

In the below **Table 7** is a breakdown of the U.S. current dollar GDP comparing 1q09 and 1q08 results for the four main components; Private Consumption

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Expenditures, Gross Private Investment, Government Consumption and Investment and net exports of goods and services. Two key points;

	1q08	1q09	% Chg
Consumption	10.0	9.9	-0.6%
Investment	2.1	1.6	-22.2%
Government	2.8	2.9	3.1%
Net Exports	(0.7)	(0.3)	-53.6%
<b>Total GDP</b>	<b>14.2</b>	<b>14.1</b>	<b>-0.4%</b>
SP500	1,323	798	<b>-39.7%</b>
Consumption	70.7%	70.5%	-0.2%
Investment	14.5%	11.4%	-3.2%
Government	19.8%	20.5%	0.7%
Net Exports	-5.0%	-2.3%	2.7%

First this has been an **investment driven recession** with neither significant change in private consumption which fell from \$10t to \$9.9t or -.6% nor government spending which increased from \$2.8t in 1Q08 to \$2.9t or +3.1%. Private investment dropped -22.2% from \$2.1t 1Q08 to \$1.6 1Q09 which was partially offset by a drop in the trade gap from negative \$706b in 1Q08 to a \$327b deficit in 1Q09. As a percent of total GDP, private investment dropped from 14.5% to 11.4% while private consumption held flat just above 70% which is somewhat surprising given a 40% decline in the S&P500 during the same period.

Secondly, this **recession has been driven by a large multi-quarter inventory reduction** including \$116b from 1Q09 GDP which equates to an additional 82bp decline in GDP. Recent data including the ISM and Philly Fed surveys suggest this downward trend has reversed in 2Q09 and will eventually turn positive and add growth.

**Table 8** depicts the breakdown of the three branches of government today as compared to the 70's with many similarities much like the stock market and economic data from that period. Obviously power is currently concentrated with a single party which historically has been difficult to sustain and even more difficult to implement populist changes; e.g., implementing wage and price controls or lowering the speed limit to 55mph.

Branch	70's	Today	Total
Senate	61	60	100
House	291	257	435
Administration	Carter	Obama	

## **FINANCIAL MARKET UPDATE**

The **stock market** performed well in 2Q09 with broad-based participation as illustrated in **Table 9** with the S&P500 ten sectors including beaten-down financials up 35.1% followed by technology +19.4%, industrials +18.0% and consumer discretionary +17.7%.

Sector	2Q09	YTD
Energy	10.1%	-3.2%
Materials	15.5%	<b>12.3%</b>
Industrials	18.0%	-7.7%
Consumer Discretionary	17.7%	<b>7.5%</b>
Consumer Staple	8.9%	-3.4%
Health Care	8.3%	-1.0%
Financials	35.1%	-4.8%
Technology	19.4%	<b>24.1%</b>
Telecom	1.9%	-6.7%
Utilities	8.8%	-4.1%
<b>S&amp;P 500</b>	<b>15.2%</b>	<b>1.8%</b>

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YTD 2009 results are much more mixed with seven of ten sectors still negative and big gains from the positive three, materials, technology and telecom pushing the price index up 1.8% by quarter end.

The below **Table 10** illustrates how the composition of the S&P500 has changed by comparing each sector's allocation with its allocation two years ago before the financial crisis and recession. Note that the financial sector has fallen from the largest at 20.9% in 2007 to 13.6% by the end of Q2; a 731bp market cap decline to the number three sector weight behind technology at 18.4% and health care at 14%. Energy and consumer staples were also large proportional gainers as many of those stocks have lower betas and thus held up better than average during the sharp selloff from Oct08 to Feb09.

<b>Table 10 - S&amp;P500 Sector Allocation</b>		
<b>Sector</b>	<b>6/30/07</b>	<b>6/30/09</b>
Energy	10.8%	12.4%
Materials	3.1%	3.2%
Industrials	11.1%	9.8%
Consumer Discretionary.	10.2%	9.0%
Consumer Staple	9.3%	12.0%
Health Care	11.8%	14.0%
Financials	20.9%	13.6%
Technology	15.5%	18.4%
Telecom	3.7%	3.5%
Utilities	3.5%	4.1%

Mid cap and Small cap stocks outperformed Large cap advancing 18.75% and 21.47%, respectively while the R1000 Large Cap Growth index +16.96% converged with the R1000 Large Cap Value index +16.79% although value still trails growth by 1,461bp YTD 2009. The divergence is

more pronounced with smaller stocks as the R2000 Small Cap Growth index has outperformed value by 1,683bp YTD. The EAFE International index jumped almost 22% in Q2 with the MSCI Emerging Market index advancing 30% both helped by a declining dollar and strengthening commodity prices throughout the quarter.

The **CRB commodity** index rallied over 11% during the second quarter as crude oil traded up from the low 50's to the high 60's with the dollar index falling below 80 and the grains flat to down. Gold has been flat and even traded down near \$900 suggesting less dollar hedgers. The CBOE (VIX) volatility index continued to drift lower during the second quarter from the upper 30's in April to low 30's by May and eventually the upper 20's at the end of June. A truly impressive stat given the measure traded well above 50 during the 4Q08 then was range bound between 40 and 50 during 1Q09.

The **bond market** drifted slightly higher during the quarter with the aggregate price index up 69bp and 1.29% YTD with corporate bonds outperforming the index while Treasury and Mortgage bond prices dropped during the quarter. The below **Table 11** depicts the price changes by segment during Q2 and YTD sorted from the best to worst Q2 price change. High yield and corporate bonds short to long maturities topped the list while TIPS and long maturity Treasury experienced the largest declines.

The benchmark ten year Treasury bond yield continues to swing in relationship to stocks with the yield bottoming around 2.5% at the start of the quarter then rising to 4% during the second week in June when the S&P500 reached

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its 2009 peak around 950. The L.T. Treasury index is down 6% for Q2 and is now down over 5% YTD 2009 as prices remain under pressure with large and steady new issuances of two, five ten and even some thirty year bonds on almost a weekly basis.

Table 11 - Bond Price Changes		
Sector	2Q09	YTD
High Yield Bonds	17.6%	13.7%
L.T. Corporate Bonds	6.5%	6.8%
Intermediate Corporate	6.2%	5.8%
S.T. Corporate Bonds	4.9%	5.4%
Intermediate Muni	0.7%	1.5%
Treasury Bills	-0.1%	-0.1%
Mortgage-Backed	-0.6%	-0.1%
1-3 Yr Treasury Bonds	-0.7%	-0.5%
Inflation Protected Bonds	-1.1%	-2.4%
7-10 Yr Treasury Bonds	-6.1%	-5.2%
Total Market	0.7%	1.3%

The ten-two Treasury spread widened to around 250bp by Mid-May and then traded sideways between 240 and 260bp through the balance of the quarter. Fed Fund and Libor continue to trade below 1% with most S.T. government funds paying very little yield. The FOMC 6/24/09 Policy Statement reiterated the Fed's continued support of mortgage rates including the purchase of \$1.25t of new agency mortgage-backed securities and up to \$200b of agency debt.

Bond price volatility remains high relative to long term averages across all segments; however, the daily stats continue to improve relative to 4q08 and 1q09. **Table 12** compares the monthly standard deviation of long term and inflation protected Treasuries with investment and non-investment grade corporate bonds. The trend is lower in all series with the biggest improvements in corporate bonds which also posted the largest Q2 price gains. The average corporate bond prices bottomed in

Mar09 at 93 and reached 99 by June concurrent with the average high yield bond price reaching 67 and 78, respectively. Inflation Protected Treasury bonds traded at a discount to the 10 year Treasury benchmark in Q2.

Table 12 - Bond Price Volatility				
Month	LT Tr	TIPS	Corp	Junk
2009-07	0.7%	0.3%	0.4%	1.7%
2009-06	1.0%	0.6%	1.0%	1.0%
2009-05	1.2%	0.9%	0.6%	1.3%
2009-04	0.7%	0.6%	1.5%	3.2%
2009-03	1.2%	2.5%	1.0%	3.8%
2009-02	0.8%	1.0%	1.6%	2.9%
2009-01	1.2%	1.0%	1.3%	2.5%
2008-12	1.8%	2.1%	3.9%	6.9%
2008-11	2.4%	1.4%	0.9%	5.1%
2008-10	1.3%	3.2%	2.2%	6.9%
2008-09	0.9%	1.2%	6.1%	4.5%
2008-08	0.7%	0.6%	0.4%	0.3%

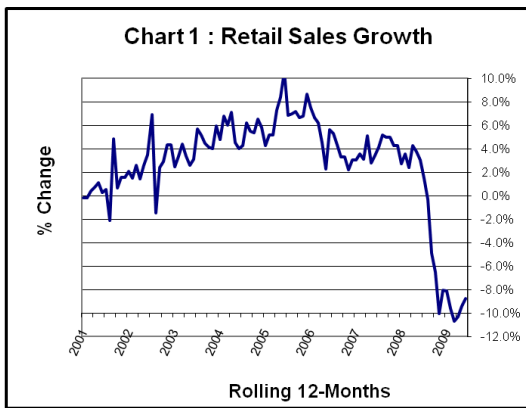
## **THE ECONOMY**

The consensus estimate for Q2 GDP has improved to around -2% as we wait for the preliminary release on July 31<sup>st</sup>. The markets will look for confirmation that the rate change of the growth rate remains positive even if growth is negative for a fourth straight quarter. New vehicle sales in Jun09 dropped 28% from Jun08 at 860k units, an annualized rate of 9.69m units, which was down slightly from May but well above the Mar09 annualized sales rate of 8.9m units. The June release also indicated that 2009 inventories levels for Ford and Chrysler have been reduced and thus should provide additional channel building during Q3. Non-durable retail inventories are also much leaner and thus should mitigate the negative inventory impact on growth for at least the balance of 2009. May retail inventories were down -1.0% with

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Apr09 down -1.3%. Remember that the economy officially entered recession in 4Q07 and the average recession is around 16 months.

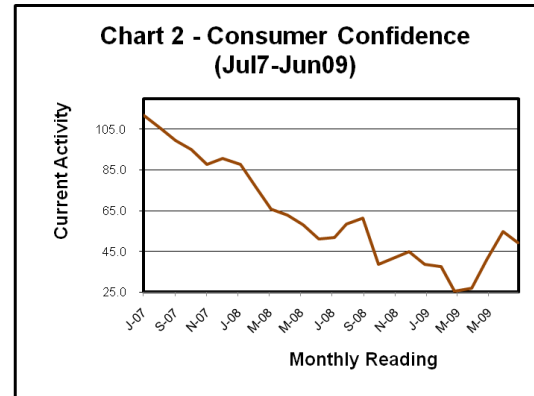
**Consumer spending** as measured by retail sales remained well below last year's level. The annual rate of decline in retail sales is improving after bottoming at -10.7% in Apr09, -10.3% May09 and -9.2% Jun09. Energy prices were sequentially higher in Q2 but well below the 2008 cycle peak with food prices stable. May durable goods orders jumped 1.8% and were also up 1.1% excluding transportation. **Chart 1** depicts this bottoming process using the rolling 12-month U.S. **retail sales growth** rate with the first print below negative 10% in Dec08 and then the retest in Apr09. This is an ugly chart, but with signs of improvement at the tail.



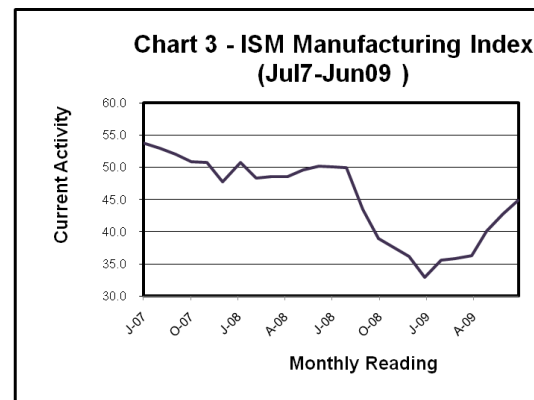
**Consumer confidence** appears to have bottomed in Feb09 when the conference Board's consumer sentiment index dropped to 25.3. **Chart 2** helps depict the recent improvement following a clearly historical collapse from well above 100 in Jul07. A statistical analysis using data for the last few decades would suggest less than a 1% chance that the index would fall to 25 which perhaps explains its rapid climb

back to 54.9 in Jun09 before dropping slightly in Jun09 to 49.4.

The U of M sentiment index exhibited a similar decline but appears to have bottomed in Nov08 at 55.3 and then held in Jun09 to close at 70.8 which is its highest reading since Jan08.



**Business sentiment** improved throughout Q2 with the Institute of Supply Management's (ISM) purchasing manager index averaging 42.9 up from an average reading of 35.9 in Q1. The ISM index has remained below 50 since Jul08 but has also steadily improved for the last six months reaching 44.8 in Jun09 after bottoming at 32.9 in Dec08.



The Philly Fed index of regional manufacturing growth remained below zero but has also improved during the quarter. The index averaged -16.5 in Q1 up from -33.6 in Q1 and well above the record low of -38.2 in 4Q08. The Jun09

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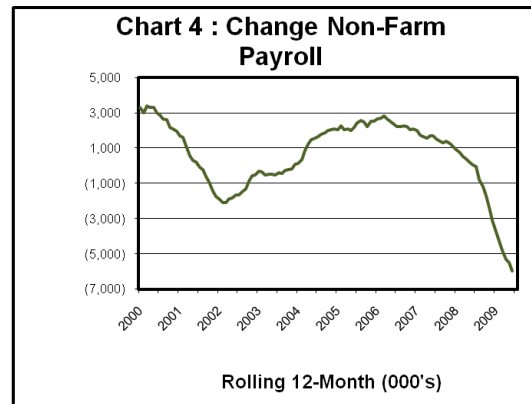
reading of -2.2 was the highest point since Sep08. **Chart 3** depicts the recent improvement in business confidence using the ISM for the last twenty four months. An ISM reading above 44 and a Philly Fed above zero correspond to increasing real GDP. The Jun09 readings seem to suggest at least slight positive growth if the past relationship between these stats and the overall economy hold during this cycle.

**Most lagging indicators like capacity utilization** continued to move lower during the quarter reaching a cycle low of 68.3% in May09. Slack capacity remains issue number one and provides the Fed confidence to keep rates low because they expect resource slack to contain cost pressure in the economy. **Industrial production** remained in negative territory for a fifth consecutive quarter with an average Q2 monthly decline of -0.8% which is a substantial improvement over -1.6% in Q1. We likely need to see the reemergence of meaningful automobile production following the Chrysler and GM bankruptcies and the July model changeover before industrial production turns positive once again. Q3 will almost certainly be better although GM still has too much inventory.

Non-farm payroll **employment** continued to contract in Q2 but at a decelerating pace with an average monthly payroll decline of -436k as compared to -691k in Q1 and -510k in 4Q08. **Total non-farm payrolls have contracted 5.962m in the last twelve months** with the unemployment rate drifting upward to 9.5%. The average hourly earnings growth rate has softened to 2.7% but is well above the CPI inflation rate which was negative in Q2.

Weekly jobless claims have eased in recent months after peaking at a cycle high above 650k. The current four-week average has been trending lower to 606k and we saw the first sub-600k print in many months for the week ending July 4<sup>th</sup>. Continuing claims are fast approaching 7m despite fewer initial or new claims. The Jan09 report of -741k lost jobs appears to be the cycle peak. These figures are very large in absolute terms and it will likely take many years to reemploy so many workers.

**Chart 4** depicts the rolling twelve month change in non-farm payrolls from 1997 to 2009 with a clear break lower during the last eighteen months. Note how much deeper the current downturn has been relative to the 2001-02 period.

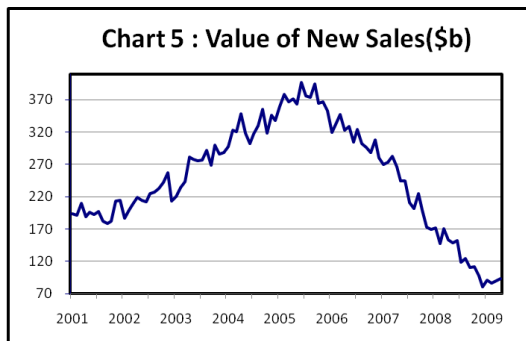


**New home sales** and housing starts have been struggling to find a bottom. New homes sales dollar volume improved to around \$94b in May09 after bottoming at \$81b in Jan09 with a cycle low unit sales level of 329k. This is a far cry from \$400b days of the boom years but at least we have likely bottomed albeit substantially below the natural demographic growth rate of a \$14t economy. The median new home price improved to \$222k in May09 after bottoming at \$202k in Mar09 while the

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average price moved higher to \$274k after bottoming in Jan09 at \$245k.

The supply of new homes for sale remains elevated at 10.2 months or 292k seasonally adjusted annualized units but has fallen five consecutive months after peaking at 12.4 months in Jan09 and is well below May08's annualized inventory of 453k units. **Chart 5** illustrates the recent turn using the annualized dollar value of monthly new home sales from Jan01 to May09.

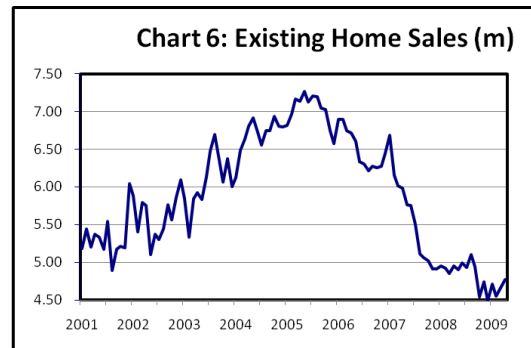


**Housing starts** reached a cycle low of 454k starts in Apr09 a 46% decline from 2008 and well below the Q1 already weak average rate of 530k. Builder sentiment remains depressed.

**Existing home sales** seem to be leveling off above 4.5m units with some signs of stabilization thus far in 2009 after 4.9m sales in 2008. **Chart 6** illustrates sales flattening around 5m in early 2008 then breaking down to around 4.5m following the credit crisis and holding above thus far in 2009. Inventory levels have held below 10 months for much of 2009 although the number of existing **homes for sale** remains high at 3.8m, down 15% from 4.48m units for sales in May08.

The national median selling price appears to have bottomed at \$164.8k in

Jan09 and subsequently improved to \$173k as of the May09 report which is still down 17% from May08. The national average selling price fell to \$207k in Jan09 before improving to \$216k by May09, down 15% from last year.



Mortgage rates dropped below 5% on numerous occasions during Q2 and have recently traded slightly above 5% despite aggressive support by the U.S. government. Lower prices and low mortgage rates will improve home affordability and should help buyers in 2009. Credit standards remain tight but improving. Mortgage applications increased after each steep decline in the ten-year Treasury bond yield which has been quite volatile in 2009. Borrowers using floating Libor or Treasury based mortgages continue to roll into very low rates.

In sum, U.S. **economic fundamentals remain weak but have improved from Q1**. Extreme monetary and fiscal policy make most predictions guess work **but a natural healing process is clearly evident in the U.S. economy**. The timing and amount is always difficult but stabilization often is a prerequisite to growth in a post-crisis period and this downturn has been one of the worst. Confidence measures have improved with six-month forward indicators suggesting 2010 growth.

APPENDIX A: U.S. Recessionary Periods - All Negative Quarters Since 1945

Quarter	GDP in billions of current dollars	GDP in billions of chained 2000 dollars	%Chg Nominal	Nominal Rolling 10 Year Avg Annual % Chg	%Chg Real	Real Rolling 10 Year Avg Annual % Chg	Period
1947q2	241	1,569	5.7%		-0.5%		1947-49
1947q3	245	1,568	7.0%		-0.2%		1947-49
1949q1	270	1,633	-7.3%		-5.9%		1947-49
1949q2	266	1,628	-5.5%		-1.2%		1947-49
1949q4	265	1,630	-3.7%		-4.0%		1947-49
1953q3	381	2,085	-0.9%		-2.4%		1953-54
1953q4	376	2,053	-5.3%		-6.2%		1953-54
1954q1	375	2,042	-0.6%		-2.0%		1953-54
1956q1	428	2,235	2.2%		-1.9%		1956-60
1956q3	439	2,250	4.8%		-0.5%		1956-60
1957q2	459	2,295	1.8%		-1.0%		1956-60
1957q4	462	2,293	-4.1%	6.1%	-4.2%	3.7%	1956-60
1958q1	454	2,230	-6.3%	5.7%	-10.4%	3.3%	1956-60
1959q3	509	2,454	0.7%	6.6%	-0.3%	4.1%	1956-60
1960q2	526	2,505	-0.6%	6.3%	-2.0%	3.7%	1956-60
1960q4	524	2,476	-3.9%	5.3%	-5.1%	3.0%	1956-60
1969q4	1,005	3,766	3.3%	6.9%	-1.9%	4.3%	1969-70
1970q1	1,017	3,760	5.2%	6.8%	-0.7%	4.1%	1969-70
1970q4	1,053	3,760	0.8%	7.2%	-4.2%	4.3%	1969-70
1973q3	1,391	4,332	5.7%	8.3%	-2.1%	4.2%	1973-77
1974q1	1,447	4,335	4.2%	8.3%	-3.4%	3.9%	1973-77
1974q3	1,514	4,306	8.0%	8.5%	-3.8%	3.6%	1973-77
1974q4	1,553	4,289	10.8%	8.7%	-1.6%	3.5%	1973-77
1975q1	1,570	4,238	4.3%	8.5%	-4.7%	3.1%	1973-77
1977q4	2,112	4,815	9.0%	9.5%	0.0%	3.2%	1973-77
1980q2	2,729	5,116	0.6%	10.2%	-7.8%	3.1%	1980-82
1980q3	2,787	5,107	8.7%	10.2%	-0.7%	3.0%	1980-82
1981q2	3,086	5,266	4.4%	10.7%	-3.1%	3.1%	1980-82
1981q4	3,196	5,263	2.2%	10.7%	-4.9%	3.0%	1980-82
1982q1	3,187	5,177	-1.2%	10.3%	-6.4%	2.6%	1980-82
1982q3	3,276	5,185	4.2%	10.1%	-1.5%	2.3%	1980-82
1990q4	5,849	7,077	0.0%	7.2%	-3.0%	3.1%	1990-91
1991q1	5,888	7,041	2.7%	6.8%	-2.0%	2.9%	1990-91
2000q3	9,862	9,837	1.6%	5.4%	-0.5%	3.3%	2000-01
2001q1	10,022	9,876	2.8%	5.5%	-0.5%	3.4%	2000-01
2001q3	10,135	9,871	0.2%	5.3%	-1.4%	3.3%	2000-01
2008q3	14,413	11,712	3.4%	5.1%	-0.5%	2.6%	2007-09
2008q4	14,200	11,522	-5.8%	4.7%	-6.3%	2.2%	2007-09
2009q1	14,090	11,361	-3.1%	4.5%	-5.5%	2.0%	2007-09